

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:MCT:WAS:RCH:TL-N-7027-00  
CMDRees

date: **APR 25 2001**

to: Team Manager Ted Shaughnessy

from: Associate Area Counsel (LMSB)  
(Heavy Manufacturing, Construction and Transportation)

subject: [REDACTED]  
Advance Payments

On February 26, 2001, we sent you our advisory opinion regarding advance payments received by [REDACTED]. We also sent a copy of the memorandum to the National Office for post review. This week we received a "mark up copy" of the memorandum on which the National Office noted changes they want made to the memorandum. In the interest of time, we have attached a copy of the "mark up" copy.

The most significant change regards Issue 4. The N.O. correctly noted that the taxpayer's [REDACTED] taxable year is the appropriate year for inclusion of income, rather than [REDACTED] if the payments are not included in the taxpayer's [REDACTED] taxable year. Other changes are not as legally significant.

Although I will be out of the office during the week of April 30, 2001, I hope you will call me before I leave or after I return if you have questions. My direct line is (804) 916-3947.

/s/ Cheryl M.D. Rees

CHERYL M.D. REES  
Senior Attorney (LMSB)

Enclosure

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Internal Revenue Service

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Advance Payments

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the I.R.S. recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to I.R.S. personnel or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on the I.R.S. and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether the taxpayer may treat the advance payment it received from the [REDACTED] as received from a long-term contract for purposes of I.R.C. § 451 and regulations promulgated thereunder.

2. Whether determinations that may be made by a TE/GE examiner regarding the nature of the Agreement For Purchase and Sale of [REDACTED] entered into by the taxpayer and the [REDACTED] will impact

the Federal income tax treatment the taxpayer must give to the advance payment.

3. Whether a \$ [REDACTED] advance payment received by the taxpayer in late [REDACTED] should be included in income for tax purposes in that year.

4. Whether, if the advance payment is not included in income for the taxpayer's taxable year ended December 31, [REDACTED] it must be included in income in the taxpayer's [REDACTED] taxable year \* pursuant to the provisions of Treasury Regulation § 1.451-5(c).  
\* (i.e., the second year following the year in which substantial advance payments are received)

5. What is the nature of the additional payment in the amount of \$ [REDACTED] made by the [REDACTED] to the taxpayer in December, [REDACTED]?

#### CONCLUSIONS

1. The taxpayer may not treat the advance payment as received from a long-term contract for purposes of I.R.C. § 451 and regulations promulgated thereunder because the contract was not a "building, installation, construction or manufacturing contract."

2. Even if a determination is made by the TE/GE agent examining the [REDACTED]'s participation in the agreement you are examining, it may be quite some time until that determination is binding upon [REDACTED] and, even then, it may not be binding upon [REDACTED] and Subsidiaries. However, the Service may not wish to be in the position of maintaining two wholly inconsistent positions. It is, therefore, our opinion that you may only want to use the agent's determination in setting up an alternative position.<sup>1</sup>

3. and 4. Limited factual development is needed before we can respond to these issues with certainty. Four alternative solutions are discussed herein and summarized on pages 8 and 9.

5. We do not yet have sufficient information to determine the nature of the additional payment made by [REDACTED] in December, [REDACTED].

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<sup>1</sup> If the determination were to be that the agreement constituted a loan that was prohibited under laws relating to Government Entities, your alternative position would be that [REDACTED] received little or no taxable income at the time of the advance payment.

## FACTS

On [REDACTED] [REDACTED] [hereinafter referred to as [REDACTED]] and the [REDACTED] [hereinafter referred to as [REDACTED]] executed their Agreement For Purchase and Sale of [REDACTED] [hereinafter referred to as the agreement]<sup>2</sup>. Under the agreement, [REDACTED] promised to provide natural gas to [REDACTED] on a monthly basis over a period of ten years for a total of [REDACTED] MMBtus of gas over the ten years. [REDACTED] agreed to make an advance payment for the natural gas in the amount of \$ [REDACTED] on [REDACTED] and nominal monthly payments.

There were also provisions for extra payments from, or to, [REDACTED] if the cost of transporting the gas by use of third parties was lower or higher than contemplated at the time of the execution of the contract. Likewise, there were provisions in the agreement to cover the procedures and possible payments that would be undertaken if [REDACTED] could not timely deliver the gas called for under the agreement in any month or [REDACTED] could not receive the amount of gas called for under the agreement. The first contract month and the first contract year were scheduled to begin on [REDACTED].

One of the provisions of the agreement was that both [REDACTED] and [REDACTED] were required to enter into commodity swap agreements with the same party prior to the date of the closing regarding the agreement. We have not seen a copy of the commodity swap agreement entered into by [REDACTED]. You did provide a supplement to the commodity swap agreement [REDACTED] entered into with [REDACTED]. The document, dated [REDACTED], stated that it was a supplement to the Master Exchange Agreement negotiated between the two companies. It appears to have made provisions to supply [REDACTED] with all of the gas, on a monthly basis, that it needed to perform under its agreement with [REDACTED]. We have not done the mathematics necessary to know if it really did provide for the total gas supply called for under the agreement we are evaluating. The commodity swap agreement was to be terminated if the agreement between [REDACTED] and [REDACTED] was terminated.

According to the information you provided, [REDACTED] did make the \$ [REDACTED] advance payment on [REDACTED], as called for

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<sup>2</sup> The copy of the agreement forwarded with you request does not contain copies of the Exhibits that were attached to the agreement.

under the agreement. You also indicated that [REDACTED] paid [REDACTED] an additional payment of \$[REDACTED] on [REDACTED]. You referred to it as both an interest expense and as deferred revenue on the Form 886-A you forwarded with your request. We have been unable to ascertain the reason for that payment from a reading of the agreement. Until you locate information which will tell us definitively what the nature of the additional payment was, we will not be referring to it as part of the advance payment and will not consider its tax treatment.

For both book and tax purposes, the taxpayer has prorated the advance payment over the ten-year period of the contract. In defending its position, it has explained to you that it is treating the income as received under a long-term contract for purposes of I.R.C. § 451 and Treasury Regulation § 1.451-3. We do not know how much of the income [REDACTED] has taken into account on its consolidated financial statements and other reports prepared for [REDACTED], [REDACTED] and subsequent years.

A Government Entities, Tax Exempt Bonds agent has informed you that she is examining the agreement between [REDACTED] and [REDACTED] from the perspective of [REDACTED]. She is evaluating whether the advance payment is, in substance, a financing arrangement under which [REDACTED] loans [REDACTED] money in order to receive illegal arbitrage earnings. We have tried to contact the agent to obtain additional information, but she has not as yet returned our calls. The form of the agreement was designed to make it look as if it were, instead, a contract for the sale of natural gas in the ordinary course of [REDACTED] business.

#### ANALYSIS

##### ISSUE 1

[REDACTED] argues that it is entitled to report income it received under its agreement with [REDACTED] as having been received under a long-term contract. Indeed, if the length of a contract were the criteria used for determining whether a contract was a "long-term" contract for purposes of I.R.C. § 451, a 10-year contract might well qualify. The length of the contract, however, is not determinative.

I.R.C. § 460(f) defines a long-term contract as "any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into." I.R.C. § 460(f). In I.R.C. § 451, Congress provided the general rule for determining the taxable year in which an item of gross income should be included in gross income for tax purposes. Even though

the wording of the statute itself does not provide an answer to the question we seek, the Treasury Regulations promulgated thereunder do. See I.R.C. § 451; Treas. Reg. § 1.451-3. With an exception that does not come into play in this case, Treasury Regulation § 1.451-3(b)(1) defines a long-term contract in the same way as does I.R.C. § 460(f). See Treas. Reg. § 1.451-3(b)(1)(i). The cases construing this section employ the commonly-used meanings for building, installation, construction or manufacturing and tend to analyze whether contracts for certain closely related services, such as those provided by an architect, may be considered long-term contracts. [REDACTED] has advanced no argument whatsoever as to why their agreement with [REDACTED] could be considered a "building, installation, construction or manufacturing" contract. The provisions of Treasury Regulation § 1.451-3(b)(1) simply do not apply. See also Notice

89-15, 1989-1 C.B. 634,

#### ISSUE 2

Even if the TE/GE examiner makes a determination that the agreement between [REDACTED] and [REDACTED] constitutes a loan and that determination is pursued to the point that it is binding upon [REDACTED], it would not necessarily be binding upon [REDACTED]. From the little we know about the Government Entities examination, it sounds as if it will be a long time until any such determination would be binding even upon [REDACTED]. Therefore, in a practical sense, it would be best to use any such determination as an alternative position to the primary position(s) you take under the law regarding taxation of advance payments.

You will need to gather additional information from the TE/GE examiner before you can frame your alternative position. We would be happy to assist you in evaluating the alternative position once that examination has progressed to the point where the agent can provide definitive information and an explanation of the evidence on which she bases her determination.

#### ISSUES 3 AND 4

For purposes of this analysis, we are assuming that the taxpayer uses the accrual basis of accounting for tax purposes and uses the calendar year. I.R.C. § 451 sets forth the general rule for determining the taxable year of inclusion of items of gross income. According to that section, such items must be included in gross income in the year in which they were received by the taxpayer unless, under the method of accounting the taxpayer uses to compute taxable income, such items are required to be accounted for in a different taxable period. I.R.C. § 451(a).

I.R.C. § 451(f)(2)(A) defines "utility services" as including:

(ii) the furnishing of gas or steam through a local distribution system, . . . and

(iv) the transporting of gas or steam by pipeline.

I.R.C. § 451(f)(2)(A).

Section 451(f) also provides that, in the case of an accrual basis taxpayer, income attributable to the sale or furnishing of utility services shall be included in gross income no later than the taxable year in which the services were provided. I.R.C. § 451(f)(1). Furthermore, the subsection states that, in determining the year in which services are deemed to have been provided, we can not rely upon the period in which the customer's meters are read or the period in which the taxpayer bills (or may bill) its customers for the service provided. See I.R.C. 451(f)(1) and (f)(2)(B).

Treasury Regulation § 1.451-1(a) provides generally that under the accrual basis of accounting, "income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." See Treas. Reg. § 1.451-1(a). Courts and the Commissioner have repeatedly held that the events that fix an accrual basis taxpayer's right to receive income occur when (1) the required performance occurs, (2) payment for the performance is due, or (3) payment for the performance is made, whichever happens first. See Schlude v. Commissioner, 372 U.S. 128 (1963); Bell Federal Savings & Loan Ass'n. & Subs. v. Commissioner, T.C. Memo. 1991-368, rev'd. on other grounds, 40 F.3d 224 (7<sup>th</sup> Cir. 1994); Rev. Rul. 84-31, 1984-1 C.B. 127.

Treasury Regulation § 1.451-5 provides specific guidance for reporting advance payments for goods. In doing so, it provides two avenues by which an accrual basis taxpayer may defer tax on the advanced payment beyond the year in which the payment is received. On its face, the agreement between [REDACTED] and [REDACTED] and the payment [REDACTED] received under the agreement appear to fall within the definition of advance payment found in Treasury Regulation § 1.451-5(a)(1)(i). The regulation provides that advance payments must be reported in the taxable year of their receipt or in the earlier of:

(a) In the taxable year in which properly accruable under the taxpayer's method of

accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, . . . and for credit purposes, or

(b) If the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to his method of accounting for purposes of such reports.

Treas. Reg. § 1.451-5(b).

<sup>+this regulation</sup> Although (a) and (b) would let a typical taxpayer defer his tax on an advance payment until the earlier of the year in which he would ordinarily report it for tax purposes <sup>(1)</sup> and the year in which he reported it for financial reporting <sup>OR (2)</sup>, [REDACTED] is not a typical taxpayer in this instance. That is because [REDACTED] improperly reported the advance payment as if it had been received under a long-term contract. Since [REDACTED] is prohibited by statute and regulation from reporting the income as if it were attributable to a long-term contract, it would make no sense to allow [REDACTED] to utilize that method for purposes of Treasury Regulation § 1.451-5(b)(1)(ii)(a) or (b).

If a review of the taxpayer's consolidated financial statements and reports used for obtaining credit actually included the advance payment in a manner reflective of the use of an appropriate accounting method, the year of its inclusion on those reports could be used as the year of inclusion in gross income.<sup>3</sup> See Treas. Reg. § 1.451-5(b)(1)(ii)(b). Even if the taxpayer's consolidated financial statements and reports for credit purposes are reflective of the use of a permissible accounting system, however, the possible deferrals offered by subsection (b) are not available if [REDACTED]'s agreement falls within the provisions of Treasury Regulation 1.451-5(c). <sup>(e.g., upon gas delivery. However</sup>

<sup>3</sup> It would be interesting to know what was contained on any credit reports that may have been given to [REDACTED] when [REDACTED] was negotiating the commodity swap agreement with it.

(FD) For example, a taxpayer who deferred income until gas delivery for tax and book purposes could use this method to defer the advance payment beyond the year of receipt under

and Treas. Reg. 1.451-5(c)(4)

That section limits the deferral period if the advance payment is "substantial", as defined in Treasury Regulation § 1.451-5(c)(3) and, in the year of its receipt of the advance payment, the taxpayer has on hand, or has available to it through its normal source of supply, goods of the kind and in a quantity sufficient to comply with the agreement regarding the sale of the goods and the taxpayer is accounting for advance payments pursuant to a method described in Treasury Regulation 1.451-5(b)(1)(ii) for tax purposes. In that case, all advance payments received by the taxpayer by the end of the last day of the second taxable year following the year in which the substantial advance payment was received that have not previously been included in income must be included in income in that second taxable year. In the case of [REDACTED], this would mean that it would have to include the advance payment on its return for its [REDACTED] taxable year. See Treas. Reg. § 1.451-5(c)(1)(i). [REDACTED] argues that it does not fall within the provisions of subsection (c) because it did not have sufficient inventory at the close of [REDACTED] to comply with its agreement with [REDACTED]. We do not have sufficient facts from which to determine whether [REDACTED]'s allegations are true, or whether It does appear, however, that [REDACTED] actually received a "substantial" advance payment according to the regulation. The question of whether [REDACTED] was accounting for advance payments pursuant to a method described in Treasury Regulation 1.451-5(b)(1)(ii) for tax purposes can not be answered without reference to its reports.

Taking into account the entirety of I.R.C. §§ 451 and 460 and Treasury Regulation § 1.451-5(b) and (c), it is our opinion that:

1. Pursuant to I.R.C. § 451(f)(1), the advance payment must be included in gross income no later than the taxable year in which the services were provided.

2. If the financial reports of [REDACTED] reveal that the advance payment was included in gross receipts under a permissible accounting method <sup>(e.g., upon gas delivery)</sup> and subsection (c) <sup>the limitation of Treas. Reg. § 1.451-5(c)</sup> does apply, [REDACTED] must include the advance payment in its [REDACTED] taxable year to the extent no portion of the payment was included in its [REDACTED] taxable year;

3. If the financial reports of [REDACTED] reveal that the advance payment was included in gross receipts under a permissible accounting method <sup>(e.g., upon gas delivery)</sup> and subsection (c) <sup>and the limitation of Treas. Reg. § 1.451-5(c)</sup> does not apply (either because the advance payment was not "substantial" or because [REDACTED] did not have sufficient inventory at the end of [REDACTED]), the advance payment <sup>may</sup> should include the advance payment in the same taxable years as it reported those sums in its reports; and <sup>or source of supply</sup>

4. If neither Treasury Regulation § 1.451-5(b)(1)(ii)(a) or

(b) apply, [REDACTED] must report the advance payment [REDACTED] the taxable year of its receipt, pursuant to Treasury Regulation § 1.451-5(b)(1)(i).

(P) Since [REDACTED] has improperly been using a long-term contract method, ~~Once the facts are further developed, if a change in the years in which the income has been reported by CES, a change in accounting period will take place and an I.R.C. § 481 adjustment will be necessary.~~

#### ISSUE 5

We could not find a provision of the agreement between [REDACTED] and [REDACTED] that called for the payment of \$ [REDACTED] in addition to the advance payment discussed above. [REDACTED] timely made the advance payment in the amount specified in the contract. On page one of the Form 886-A that you forwarded to our office, you indicated that it received interest from [REDACTED] because it received the advance payment on [REDACTED] rather than on [REDACTED]. It seems that [REDACTED] should have paid, rather than received, interest on account of an early payment.<sup>4</sup> Furthermore, when you set out the accounting entries, you labeled the positive sum on one line as an interest expense to [REDACTED] and on the next line as deferred interest.

You might ask the taxpayer to show you its book entries regarding the smaller payment and to show you in the contract where the interest was called for. If you are able to clarify the facts regarding this sum, we will be glad to assist in determining how and when it should be properly be taxed.

/s/ Cheryl M.D. Rees

CHERYL M.D. REES  
Senior Attorney (LMSB)

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<sup>4</sup> In fact, pursuant to the agreement, the payment was not "early" and there was no provision for the payment or receipt of interest if it had been.